Attachment 3

MEMORANDUM

To: Members of the Investment Committee
California Public Employees' Retirement System

Date: March 14, 2011

From: Pension Consulting Alliance, Inc. (PCA)

RE: Real Estate Performance through December 31, 2010

PCA has received and reviewed Wilshire's Fourth Quarter 2010 Executive Summary of CalPERS' Investment Performance as it relates to the Real Estate Portfolio. The following items should be considered in your assessment of Real Estate's performance:

- In an illiquid asset class populated with multi-year partnerships, longer term results are more significant than those of a shorter duration. Over all periods under consideration the CalPERS total real estate performance has underperformed the Policy Index. **This has been primarily driven by the vintage 2006-2007 investments' poor performance in the real estate portfolio and, therefore, the short-term results continue to warrant close scrutiny**. A material portion of these investments were made in opportunistic real estate funds and assets which did not experience the recovery in valuations recorded by lower risk, core properties during the fourth quarter and full year results for 2010.

- The total Real Estate Portfolio produced a 3.3% return during the quarter and a -5.1% return over the trailing year compared to the Policy Index returns of 4.6% and 9.3%, respectively.

- The Public REITs, which represent approximately 7.2% of the market value of the Real Estate Portfolio, had a positive quarter and produced a 6.2% return, and a 19.1% return over the trailing one-year.

- The Core Portfolio experienced strong performance turning in a return of 11.8% in the fourth quarter. The NCREIF Property Index is reported with a lag of one quarter, and showed an increase of 3.9%. PCA believes this difference will not be sustained as NCREIF results are updated. The declining direction of the Core Portfolio's values was reversed towards the end of 2010 due to high investor demand for stabilized assets and increasingly available low cost financing. This was particularly true in major coastal cities, and in the apartment and retail sectors.

- The March 31, 2010 appraisals captured the impact of eroding fundamentals on income and appreciation, leverage levels, and capital market valuation declines. These trends did not generally continue during the last half of 2010, though demand remains relatively weak. The domestic economic recovery and the perceived continuation thereof, caused a firming (but not much increase) in rental and occupancy rates in the second half of the year.

- Over the long-term, the performance in the real estate portfolio continues to be influenced by four primary factors described in prior quarters' summaries. First, capital markets have had significant impact on real estate property valuations. Continued low interest rates and an easing of credit requirements were observed during the quarter compared to earlier in the year. Second, macro-economic factors have had a deleterious effect on rents and net operating income. Demand has not increased to any significant degree in most office markets nor industrial markets. There is appetite in multifamily residential, and consumer spending has buoyed the retail sector and kept occupancy rates at previous or slightly increased levels. The final two factors are related to the exposure in the CalPERS real estate portfolio to non-stabilized assets (value added and opportunistic, which still account for more than half the value of the portfolio) with higher amounts of leverage. These final two factors have exacerbated the recent underperformance compared to the benchmark as non-stabilized assets provide less income to insulate valuation declines and increased leverage magnifies returns in upward and downward market cycles.

- The market value of the Real Estate Portfolio as of December 31, 2010 was $16.6 billion, which represents an increase of approximately $2 billion, or 13% from last year (December 31, 2009). The increase in value is attributable primarily to the deleveraging of the Real Estate Portfolio.

- As of December 31, 2010 the real estate asset class represented 7.3% of the total CalPERS portfolio, below the target allocation of 10.0%.

- The under allocation to real estate should give Staff the flexibility to take advantage of potential opportunities that may present themselves due to the distress in the real estate market. Since the beginning of 2011, approval was given to annual investment plans from the five real estate strategic partners to invest up to approximately $1.8 billion in their portfolios to accomplish acquisition, capital improvement and deleveraging objectives. Together with the expected trends of generally increasing property values and the funding of previously committed amounts to commingled funds, these new amounts, if invested, will bring the real estate portfolio closer to the target allocation.

- At the February 2011 Investment Committee meeting, the proposed Real Estate Strategic Plan was approved. This plan will provide for the implementation of the revised role of real estate as described in the recent asset allocation study. This role will be primarily to provide reliable current income and diversification from public and private equities' return characteristics. Hence, the portfolio will be shifted in emphasis over time towards strategic, stabilized, domestic core assets held for a longer term, and away from more tactical, opportunistic, appreciation-oriented investments held for a shorter term.

- The partnership review process initiated by Staff to evaluate the risks and merits of individual investments and investment managers was completed during the fourth quarter. More than 60 managers were reviewed. Information gathered through this review process yielded important lessons and proved valuable in formulating the implementation of the new real estate strategy, including shifting towards a more direct separate account focus, with higher levels of alignment between CalPERS and its operating partners, and away from commingled funds with lower levels of control and remediation available.

- Staff has been active in exiting less desirable partnerships and completed the transfer of more than $10 billion of the slated assets to vetted, strategic replacement partners.

- The Loan-To-Value (LTV) policy limit is no longer in breach for the total portfolio with a 54% LTV; however, the Core Portfolio is still out of compliance. Staff continues to implement a deleveraging plan that addresses loan-to-value (LTV) considerations, recourse debt limits, and existing, prospective and potential covenant breaches and defaults. These efforts are expected to stabilize the portfolio and relieve Staff from the intense asset-level management responsibilities that have accompanied the distressed debt situations that pervade the portfolio.